

**Communications
Workers of America**
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July 2, 1998

1998

Ms. Magalie Roman Salas, Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

RE: Ex Parte Notice
CC Docket No. 97-211 (Applications of WorldCom and MCI for Transfer of Control of MCI to WorldCom)

Dear Ms. Salas:

On July 2, 1998, the Communications Workers of America sent the attached report, "Taking MCI Out of Local Competition" to the Commission staff listed below. This report describes the negative impact that the merger will have on local residential consumers.

In accordance with the Commission's rules, I submit two copies of this notice and of the report to the Secretary of the Commission for inclusion in the public record of these proceedings.

Sincerely,



Debbie Goldman, Research Economist
Development and Research Department

Enclosure

cc: John Nakahata, Kathryn Brown, Regina Keeney, Daniel Phythyon, Thomas Powers, James Casserly, Paul Misener, Jane Mago, Rick Chessen, Susan Fox, Helgi Walker, Karen Gulick, Paul Gallant, Ari Fitzgerald, Peter Tenhula, Kyle Dixon, John Muleta, Larry Strickling, Carol Matthey, Ruth Milkman, Michelle Carey, Jennifer Fabian, Susan Launer, Michael Pryor, Matt Nagler, Michael Kende, Christopher Wright, Richard Welch, Dale Hatfield, Michael Nelson, Diane Cornell, David Solomon, Paula Michele Ellison, Kevin Martin, Gregory Cooke, Rebecca Dorch

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TAKING MCI OUT OF LOCAL COMPETITION

ELIMINATING FRIENDS AND FAMILY

A financial analysis of why the combined
MCI-WorldCom will have fewer resources
to invest in the local telephone market.

EXECUTIVE SUMMARY

MCI and WorldCom claim that the main public interest benefit of their proposed merger is the creation of a stronger competitor with the financial resources to launch an assault on the incumbent monopolies in the local exchange. The two companies claim that a combined MCI-WorldCom will build networks to serve all consumer segments in the local telephone market, finally bringing to consumers the benefits of competition promised in the Telecommunications Act of 1996.

That is their claim. But it simply is not true. As this report makes clear, a combined MCI-WorldCom will be driven by financial imperatives to avoid serving the "less profitable" residential consumer market. The merger will transform today's MCI from a company known for its successful marketing to residential customers into a new MCI-WorldCom focused exclusively on the business market. While Wall Street may applaud the reorientation of MCI from mass residential markets to an integrated business-only communications company, the public at large will suffer. The economics of the merger dictate that the combined MCI-WorldCom will stop competing for the business of residential customers.

Ironically, the merger between MCI-WorldCom simultaneously creates a company with a weaker balance sheet by traditional measures, yet one which the financial community embraces because it will abandon residential customers and arbitrage "access charges" utilized to subsidize local service.

The new MCI-WorldCom will be a financially weaker company for two reasons: 1) WorldCom is paying at least a \$28.6 billion premium price over book value for MCI; and 2) WorldCom must borrow \$7.4 billion to pay cash to British Telecom for its share of MCI.

As a result, a straightforward traditional financial analysis of the combined MCI-WorldCom finds that:

- The combined MCI-WorldCom will be less efficient in generating revenue and income off its asset base.
- The combined MCI-WorldCom will have reduced capacity to finance capital expenditures with internal resources.
- The combined MCI-WorldCom will be more highly leveraged and will have reduced ability to raise future debt and to cover interest payments.
- The combined MCI-WorldCom's projected profit margins require draconian cost-cutting in capital expenditures and operating costs. If these so-called "synergy" savings are not achieved, the combined company will not meet Wall Street's expectations for above average margins, growth, and earnings.

To justify the increased risk associated with its weakened financial condition, MCI and WorldCom must promise investors superior margins, earnings, and growth from the combined MCI-WorldCom. Wall Street is gambling that MCI-WorldCom will deliver on its promise. To meet Wall Street's expectations, the new combined company's top management will be driven to invest its more scarce and expensive capital resources to seek adequate returns in the only business strategy that makes sense. And the only business strategy that makes sense, in the words of WorldCom's Chief Operating Officer John Sidgmore, is one with a "religious focus" on serving high-margin business customers with a bundled package of telecommunications services.¹ In fact, as the analysis in this report demonstrates, the financial terms of the merger will require the combined MCI-WorldCom to avoid investments in networks serving the lower-margin residential market. The result will be less competition, not more.

INTRODUCTION

In a January 1998 letter to the Federal Communications Commission, MCI and WorldCom CEOs Bert Roberts and Bernard Ebbers wrote that a combined MCI-WorldCom will build networks to serve residential consumers in the local market "where business opportunities exist."²

As this report makes clear, the financial conditions of the combined MCI-WorldCom will never support business strategies aimed at building networks to serve residential consumers in the local market. Rather, the \$28.6 billion premium price that WorldCom is paying for MCI, the increased \$7.4 billion debt load, and the \$20 billion in cost-cutting over the next five years on which the deal is based together lead to one financial imperative for the combined company: an exclusive focus on high-margin corporate and global clients. This exclusive focus explodes the myth that this merger will lead to greater local competition.

We arrive at this conclusion based on an examination of MCI-WorldCom's financial statements for the nine-month period ended September 30, 1997, which MCI and WorldCom provided to shareholders while seeking merger approval.³ The body of this report analyzes those financial statements using a standard financial ratio analysis methodology. (The methodology is described in detail in the appendix.) The report is divided into two sections.

¹ Mike Mills, "WorldCom Would Shift MCI's Focus; Bidder Plans to Shed Residential Service," *Washington Post*, Oct. 3, 1997.

² Letter dated January 26, 1998 to the Honorable William Kennard from Bernard J. Ebbers and Bert C. Roberts.

³ WorldCom Joint Proxy Statement/Prospectus, Filed as amendment No. 3 to SEC Form S-4, January 22, 1998.

In Part One, we analyze the two major negative changes on the balance sheet and income statement of the combined company: (1) the very large increase in the amount of goodwill and intangible assets and (2) the increase in the amount of debt. We examine how these two changes increase the combined company's expenses, thereby reducing its bottom line profits.

In Part Two, we analyze four categories of financial ratios and discuss the implication of these ratios for the combined company's financial condition. Based on this analysis, we reach four conclusions:

- The combined MCI-WorldCom will be less efficient in generating revenue and income off its asset base.
- The combined MCI-WorldCom will have reduced capacity to finance capital expenditures with internal resources.
- The combined MCI-WorldCom will be more highly leveraged and will have reduced ability to raise future debt and to cover interest payments.
- The combined MCI-WorldCom's projected profit margins require draconian cost-cutting in capital expenditures and operating costs. If these so-called "synergy" savings are not achieved, the combined company will not meet Wall Street's expectations for above average margins, growth, and earnings.

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These facts create the financial imperative for the combined MCI-WorldCom to transform today's MCI into a new company with a "religious focus" on the corporate and global markets. The new company will forgo long-term investments in local markets, which will result in less competition, not more. "Business opportunities" to build networks which will serve residential customers will never exist for MCI-WorldCom.

IMPACT OF THE MCI-WORLDCOM MERGER ON THE COMBINED COMPANY'S FINANCIAL STATEMENTS

Goodwill and Intangibles Will Increase By \$28.6 billion.

The merger will add at least \$28.6 billion in goodwill and intangibles to the combined company's balance sheet. This represents the premium price that WorldCom is paying for MCI.

According to standard accounting practice, goodwill and intangibles represent the difference between the purchase price and the book value of the tangible assets of a company. The purchase price that WorldCom is paying for MCI is \$39.9 billion. The book value of MCI is \$11.3 billion. The difference of \$28.6 billion represents the premium price, or goodwill and intangibles, that will be added to the combined company's balance sheet.⁴

⁴ This adjustment represents the excess over book value being paid by WorldCom to purchase MCI's assets. This figure is conservative because it is based on the assumption that WorldCom stock will trade between \$29 to \$41 at the closing of the merger and, therefore, based on the merger agreement, WorldCom will pay \$51 per MCI share. As WorldCom stock rises above \$41, the amount of goodwill and intangibles added to the balance sheet also increases. As of the date of this analysis, WorldCom stock was trading at \$45, which means a \$42.9 billion purchase price and \$31.6 billion in goodwill will be added to the balance sheet at closing.

WORLDCOM IS PAYING A \$28.6 BILLION PREMIUM PRICE FOR MCI

WorldCom pays for MCI*	\$39.9 billion
MCI Book Value	-\$11.3 billion
	<hr/>
Difference ("Premium")	\$28.6 billion

*Based on WorldCom stock price between \$29 and \$41 per share.
The premium price has actually increased since then because the price of WorldCom stock has increased above the high end of the "collar" set in the merger agreement of \$41 per share.

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WorldCom's balance sheet today is already dominated by an extraordinary amount of goodwill and intangible assets, reflecting WorldCom's five-year acquisitions binge. As seen in the chart below, goodwill and intangibles already constitute almost two-thirds (62.5 percent) of WorldCom's total assets. This is in sharp contrast to the rest of the telecommunications industry average and to MCI today, in which only 11.1 percent and 9.6 percent, respectively, of assets are intangible assets.

GOODWILL & INTANGIBLES DOMINATE THE NEW MCI-WORLDCOM

	Goodwill & Intangibles as % of Total Assets	Tangible Assets as % of Total Assets
MCI	9.6%	90.4%
Major Telcom Co. Avg.	11.1%	88.9%
WorldCom	62.5%	37.5%
New MCI - WorldCom	61.6%	38.4%

Source: WorldCom Joint Proxy Statement/Prospectus, Amendment No. 3 to SEC Form S-4, January 22, 1998.

The new combined MCI-WorldCom will closely resemble today's WorldCom with its high proportion of goodwill and intangible assets. After the merger, almost two-thirds (61.6 percent) of the combined company's assets will be goodwill and intangibles, roughly similar to today's WorldCom.

According to textbook definition, goodwill is an intangible asset that represents future earnings greater than the average in the industry.⁵ In other words, after the merger, two-thirds of the combined company's assets will consist of the expectation for above average future margins, growth, and earnings.

⁵ Kermit D. Larson and Barbara Chiappetta,
Fundamental Accounting Principles, 14th
edition, Chicago: Irwin, 1996, p. 429.

The additional goodwill on the combined MCI-WorldCom's books will have an impact on the company's bottom line. Standard accounting practice requires a company to amortize and depreciate goodwill as an expense, which in turn reduces the firm's net income (profit). MCI-WorldCom will book an additional \$716 million in annual goodwill expense each year as a result of the merger, which in turn will reduce its net income by the same amount.⁶

These two facts alone — the addition of \$28.6 billion in goodwill and the resulting reduction in net income by \$716 million annually — have powerful negative ramifications for the income-generating capacity, productivity, and ultimately, business strategy of the combined company.

Wall Street has supported the merger in anticipation that the new MCI-WorldCom will generate higher than average profits, thereby justifying the excessive level of goodwill. However, Wall Street also knows that above average margins cannot be realized if MCI-WorldCom pursues low-margin local markets.

Merger adds \$7.4 billion in long-term debt.

The combined MCI-WorldCom will add \$7.4 billion in long-term debt to its balance sheet. This is the amount that WorldCom will have to borrow to pay British Telecom for its 20 percent stake in MCI.⁷ As a result, the interest expense on MCI-WorldCom's income statement will increase by \$484 million annually.⁸ The added debt and interest expense have powerful negative ramifications for access to future capital needed for building a telephone network, and ultimately, for the business strategy of the combined company.

WorldCom acknowledges this fact in its 1997 annual report filing with the Securities and Exchange Commission. WorldCom notes that as a result of the merger "the cash flow required to service WorldCom's debt may reduce its ability to fund internal growth, additional acquisitions, and capital improvements."⁹

FINANCIAL RATIO ANALYSIS OF THE MERGER

In this section, we use standard financial ratios to analyze the financial strength and business imperatives of the combined MCI-WorldCom. The ratios are computed using line items from the pro forma financial statements provided to shareholders in merger-related documents.¹⁰ (A more detailed description of the methodology and a set of financial statements are in the appendix.)

⁶ \$537 million for the nine months ended September 30, 1997.

⁷ The \$7.4 billion includes \$6.8 billion to buy British Telecom's 20 percent interest in MCI plus other transaction costs of \$510 million, which includes a \$465 million inducement fee paid to BT.

⁸ \$363 million for the nine months ended September 30, 1997. This is based on WorldCom's incremental borrowing rate of 6.5 percent.

⁹ WorldCom 1997 SEC Form 10-K, filed March 27, 1998.

¹⁰ WorldCom Joint Proxy Statement/Prospectus, filed as amendment No. 3 to SEC Form S-4, January 22, 1998. The financial statements are for the nine months ended September 30, 1997.

We have generated four categories of financial ratios to analyze the combined company's financial condition. They are:

- **Asset productivity and income generating capacity ratios.** These measure the ability of a firm to generate revenue, cash, profits, and earnings from its asset base.
- **Working capital and liquidity ratios.** These measure the amount of cash and cash equivalent financial resources a firm has to finance capital expenditures internally.
- **Leverage and interest coverage ratios.** These measure the ability of a firm to raise additional debt and make interest payments as well as the cost of future capital.
- **Profitability and income margin ratios.** These measure the ability of a company to convert revenue into profits.

Each of these is presented below.

Asset productivity and income generating capacity ratios:

MCI-WorldCom will be less efficient in generating revenue and income off its asset base.

In this section, we examine five ratios to analyze the combined company's ability to generate revenue, cash, profits, and earnings from its asset base. On three of the five measures, the combined MCI-WorldCom shows weaker asset productivity than does stand-alone MCI.

- **Total revenue/total assets:** The combined MCI-WorldCom will generate less than half the revenue per dollar of asset than does today's MCI. MCI today generates 59 cents for every dollar of asset. The combined MCI-WorldCom will generate only 28 cents for every dollar of asset, which is only 2 cents more than the stand-alone WorldCom. This is the logical outcome of adding \$28.6 billion in non-productive assets to the MCI-WorldCom balance sheet.
- **Net income/total assets, operating income/total assets and net income/PP&E:**¹¹ Each dollar of the combined MCI-WorldCom's assets will produce 0.2 cents less in net income than MCI's assets do today. The combined company will generate 1.4 cents per asset dollar compared to 1.6 cents for the stand-alone MCI. This is because the combined company's operating cost savings will not offset the increase in interest and amortized goodwill expenses caused by the merger. However, the operating income per dollar asset for the combined company at 4.8 cents does increase from the 3.9 cents of the stand-alone MCI as does the net income/PP&E ratio from 2.9 cents to 6.1 cents. This is the result of the large operating cost reductions of \$2.5 billion in the first year projected because of the merger. The combined company must achieve these draconian "synergy savings" in order to boost its operating income/asset ratio and net income/PP&E ratios. Without the "synergy savings," both these ratios decline for the combined company.

¹¹ PP&E stands for Plant, Property, and Equipment

¹² EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization.

- EBITDA/total assets:¹² The EBITDA per asset dollar of the combined MCI-WorldCom is 7.8 cents, down from 9.3 cents per asset dollar for MCI alone. EBITDA is often used to approximate the cash flow generated from operations. The merged entity will have less ability to generate cash from its operations than the stand-alone MCI.

ASSET PRODUCTIVITY & INCOME GENERATING CAPACITY RATIOS			
	MCI	WorldCom	MCI-WorldCom with synergies
Total revenue/Total assets	58.9%	25.7%	27.5%
Net income/Total assets	1.6%	1.1%	1.4%
Operating income/Total assets	3.9%	3.5%	4.8%
Net income/PP&E	2.9%	4.1%	6.1%
EBITDA/Total Assets	9.3%	6.7%	7.8%

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Taken together, these asset productivity ratios show that the merger is not predicated on making MCI's assets more "efficient" or more "productive." Rather, our analysis suggests that the opposite is true. The combined MCI-WorldCom will, in fact, be less inefficient and less productive. As the financial ratios demonstrate, the combined MCI-WorldCom will have less capacity to generate sales and income from its assets because the combined company will be saddled with an extraordinary amount of goodwill and intangible assets.

Working capital and liquidity ratios:

MCI-WorldCom will have reduced capacity to finance capital expenditures with internal resources.

We use three ratios to measure the combined MCI-WorldCom's amount of cash and cash equivalent resources on hand, and its ability to convert its assets into cash. These measures are important because they indicate the combined company's ability to finance internally the capital expenditures required to build a local telephone network.

On all three measures, the combined MCI-WorldCom will be less able to finance capital expenditures internally than the pre-merger MCI. This is true even when the synergy savings are factored in.

- Working capital: Working capital is current assets minus current liabilities. This indicates how much cash or cash equivalent resources a company has at any one time to fund capital expenditures. The addition of WorldCom's \$245 million deficit in working capital to MCI's \$2.7 billion working capital deficit results in a combined MCI-WorldCom working capital deficit of \$2.9 billion. In short, the combined company will have no internal resources with which to finance growth, and will be saddled with an even higher working capital deficit than MCI's today.

- **Current assets/total assets and PP&E/total assets:** These two ratios measure a company's liquidity. The first ratio, current assets/total assets, measures the portion of total assets that are cash or cash equivalent, which can be used to fund growth. The combined MCI-WorldCom's current assets/total assets ratio of 8.7 percent is less than half of pre-merger MCI's 18.6 percent. The second ratio, PP&E/total assets, measures the portion of total assets that are invested in the physical plant (i.e. the telephone network) and can be disposed if necessary to fund growth. The combined MCI WorldCom's PP&E/total assets ratio is 23.1 percent, less than half that of pre-merger MCI's of 55.8 percent. This ratio indicates that the combined MCI-WorldCom will have far less ability to use asset sales as a means to fund capital expenditures. Again, this is primarily because a very small portion of the combined company's total assets is tangible.

WORKING CAPITAL & LIQUIDITY RATIOS			
	MCI	Worldcom	MCI-WorldCom with synergies
Working Capital (\$ millions)	\$(2,724)	\$(245)	\$(2,969)
Current Assets/Total Assets	18.6%	7.8%	8.7%
PP&E/Total Assets	55.8%	26.0%	23.1%

Leverage and interest coverage ratios:

MCI-WorldCom will be more highly leveraged and will have reduced ability to raise future debt and to cover interest payments.

We use seven ratios to gauge the ability of the combined company to meet its debt service obligations and raise future debt. As discussed earlier, the combined MCI-WorldCom will have to pay additional interest for carrying \$7.4 billion in merger-related debt. As a result, the combined company shows more weakness on all seven measures.

- **Interest coverage ratios:** These four ratios measure the ability of a firm to cover its interest expense. For these ratios, a higher ratio indicates stronger financial condition. On all four measures, the combined MCI-WorldCom will have less ability to meet the demands placed on it by its creditors. The operating income/interest ratio declines from 5.5 for the pre-merger MCI to 4.4 for the combined company. The net income/interest ratio declines from 2.3 for MCI to 1.3 for the combined company. The EBITDA/interest expense ratio declines from 13.1 for MCI to 7.2 for the combined company. And the fixed charge coverage ratio (EBIT/interest) declines from 4.7 for MCI to 4.2 for the combined company. The proposed merger synergy savings are insufficient to offset the increased debt load placed on the new company.

- **Leverage ratios:** Three ratios are used to measure leverage, or the amount of a company's assets that are committed to debt. These indicate the ability to raise more debt for capital requirements. On all three measures, the combined company will be much more leveraged, with a greater portion of its assets tied up with debt. Comparing the combined company with pre-merger MCI, the EBITDA/debt ratio declines from .70 to .35; the debt/equity ratio increases from .29 to .36; and the debt to tangible assets ratio increases from .15 to .59. As a result, MCI-WorldCom will have less ability to raise future debt by using its assets as collateral.

LEVERAGE & INTEREST COVERAGE RATIOS			
	MCI	WorldCom	MCI-WorldCom with synergies
Interest Coverage Ratios			
Operating Income/Interest	5.47	3.06	4.43
Net Income/Interest	2.26	0.94	1.31
EBITDA/Interest Expense	13.10	5.95	7.21
Fixed Charge Coverage (EBIT/Interest)	4.67	3.05	4.25
Leverage Ratios			
EBITDA/Debt	0.70	0.26	0.35
Debt to Equity	0.29	0.40	0.36
Debt to Tangible Assets	0.15	0.69	0.59

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Taken together, the interest coverage and leverage ratios are the most important measures of financial strength. Future lenders closely examine these ratios when calculating the cost of a loan. We have already seen that the combined MCI-WorldCom will not have internal resources with which to finance capital expansion. Thus, the combined company will have no alternative but to turn once again to the capital markets, the debt market in particular, to raise money for growth.¹³ When the combined company does so, potential investors and bond buyers will view the new company as a significantly weaker company financially than the old MCI, and will demand greater interest rates to cover the increased risk inherent in the company's financial structure. MCI's credit rating has already been downgraded as a direct result of its proposed merger with WorldCom.¹⁴

Thus, it will be more expensive for the combined MCI-WorldCom to build its local telephone network than for the present MCI. As a result, the combined MCI-WorldCom will have to commit scarce and expensive capital resources to the most profitable and cash generating lines of business. In the local exchange market, the combined MCI-WorldCom will be forced by the financial imperatives we have

¹³ The combined company will most likely not tap into the equity market anytime in the foreseeable future because it has already issued a significant amount of stock to finance its past acquisitions. Further, this would be an attractive option since the combined company will not sustain a hyper-valued price/earnings (P/E) ratio after the merger. The new company's only real choice will be to rely on the debt market for its capital requirements.

¹⁴ Moody's downgraded MCI senior debt rating to Baa2 from A2. Moody's Investor Service press release, April 16, 1998.

described to concentrate on high-margin segments of the market. Whereas the old MCI would have had more options to pursue profitable but lower margin segments of the market (such as small businesses and residential customers), the combined MCI-WorldCom will have seriously limited options.

This will also place an enormous burden on the combined MCI-WorldCom to meet its cost-cutting synergy forecasts. If the combined company fails to do so, it may be unable to meet its interest obligations. Without the synergy savings, the combined company's operating income is only twice the value of its interest payments and its net income will cover just 14 percent of its interest payments.

Profitability and income margin ratios:

MCI-WorldCom's projected profit margins require draconian cost-cutting in capital expenditures and operating costs. If the "synergy" savings are not achieved, the combined company will not meet Wall Street's expectations for above margins, growth, and earnings.

In this section, we compare the combined company's projected profit margins with and without the synergy savings to pre-merger MCI and pre-merger WorldCom using three profitability ratios. On all three measures, the combined MCI-WorldCom will exceed pre-merger WorldCom's profit margins only after the projected synergy savings are included. In other words, absent drastic cost cutting measures (valued at \$20 billion in the next five years) and a re-orientation of MCI's current strategy, the new MCI-WorldCom will not be able to meet shareholder expectations for above average growth and profits.

- Operating income margin: Without synergy savings, the combined MCI-WorldCom's operating income margin is 7.9 cents on the dollar, which is half WorldCom's current 13.5 cents. Only after factoring in synergy savings does the combined company's operating margin improve to 17.5 cents.
- EBITDA margin: Without synergy savings, the combined MCI-WorldCom's EBITDA margin of 18.8 cents is lower than WorldCom's current 26.2 cents on the dollar. Only after factoring in synergy savings does the combined company's operating margin improve to 28.4 cents on the dollar.

Net income margin: Before synergy savings, the combined MCI-WorldCom's profit (net income) margin of 0.6 cents is lower than both MCI's (2.7 cents) and WorldCom's (4.1 cents). Factoring in synergy savings is the only way that the combined company can earn the higher profit margin of 5.1 cents on the dollar.

PROFITABILITY & INCOME MARGIN RATIOS				
	MCI	WorldCom	MCI-WorldCom without synergies	MCI-WorldCom with synergies
Operating Income Margin	6.5%	13.5%	7.9%	17.5%
EBITDA Margin	15.7%	26.2%	18.8%	28.4%
Net Income Margin	2.7%	4.1%	0.6%	5.1%

CONCLUSION

This analysis of key financial ratios comparing pre-merger MCI with the combined MCI-WorldCom shows that the new company will be a bigger, but financially weaker, company. Despite MCI and WorldCom's claims, the combined MCI-WorldCom will be a less powerful competitor in the local exchange market, with fewer resources available to break into the stronghold of the incumbents.

The combined MCI-WorldCom will be less efficient, with fewer productive assets, and less able to utilize its assets to generate more revenue and income than the pre-merger MCI.

The combined MCI-WorldCom will have less cash and cash equivalent resources with which to finance internally the build-out of a local network. As a result, the combined company will have to rely more on external sources of funding for its capital requirements to build a local network. However, the new company will be able to amass less debt in the future to finance network construction, because it will be more leveraged and its cost of capital will have increased. The combined company will have to pay higher interest rates to attract capital investment than the pre-merger MCI.

Finally, the combined MCI-WorldCom will have to realize draconian "synergy" savings and re-orient its business strategy to realize the profit margins promised to Wall Street. The combined company will be under financial pressure to impose these large cost-cutting "synergies" in an effort to position the new company in the same sort of high-margin market that WorldCom is pursuing today.

As a result of these financial conditions, the combined company will have less financial latitude in pursuing all lines of business. WorldCom will be forced by these financial imperatives to re-orient MCI along the lines of its current strategy: that is, to focus on high-margin corporate and global segments of the telecommunications market and forgo residential market competition.

Contrary to MCI's and WorldCom's public claims, the MCI-WorldCom merger will not provide the consumer benefit of increased competition in the local exchange for residential consumers. The financials of the deal make it crystal clear that such business opportunities will never exist.

APPENDIX. RESEARCH METHODOLOGY AND DATA

FINANCIAL STATEMENTS

We use data in the January 22, 1998, WorldCom Joint Proxy Statement/Prospectus distributed to shareholders to generate the attached balance sheets and income statements that form the basis for our analysis.¹⁵

- COLUMNS A-D: The data used for MCI historical, WorldCom historical, the pro forma adjustments to the combined company's figures, and MCI-WorldCom pro forma combined figures are taken directly from the Joint Proxy Statement. The noteworthy pro forma adjustments to the balance sheet (Column C) were the addition of \$28.6 billion in goodwill and intangible assets¹⁶ and \$7.4 billion in long-term debt.¹⁷ The income statement was also adjusted to include an addition of \$537 million in depreciation and amortization expense¹⁸ and an addition of \$363 million in interest expense.¹⁹ As a result, the net income is decreased by \$506 million.
- COLUMN E: We adjusted the income statement to reflect the impact of the "revised estimated synergies" for 1999 – the first year of operations after the merger. All the figures for the revised estimated synergies are based on MCI's and WorldCom's projections in the Joint Proxy Statement/Prospectus. The adjustments include the following: Line costs and SG&A expenses were decreased by \$1,125 million and \$750 million, respectively.²⁰ The income tax provision was increased \$975 million.²¹ The net income was increased by \$900 million, completely as a result of \$1,875 million in cost cutting. There were no adjustments to the balance sheet for the synergies.
- COLUMN F: We then calculated MCI-WorldCom pro forma combined figures to reflect the revised estimated synergies.

billion in goodwill will be added to the balance sheet at closing.

¹⁷ This adjustment represents additional borrowing of \$7.4 billion for the purpose of financing the cash payment to British Telecom of \$6.8 billion for its 20 percent stake in MCI, and other estimated transaction costs of \$510 million (which includes a \$465 million fee paid to BT).

¹⁸ The additional \$28.6 billion in goodwill added to the balance sheet will be amortized over a forty-year period.

¹⁹ The additional interest expense was based on WorldCom's estimated incremental borrowing rate of 6.5 percent. Each percentage point increase in WorldCom's borrowing rate will add an additional \$74 million in annual interest expense.

²⁰ These amounts represent nine months of synergy savings based on annual savings of \$1.5 billion in line costs and \$1.0 billion in SG&A expenses in 1999 projected by WorldCom.

²¹ The estimated synergies are pre-tax savings. Because of purchase accounting treatment, the amortization of goodwill is not a tax-deductible expense. Therefore, the effective income tax rate for MCI-WorldCom increases from 39 percent to 52 percent. Other major telecom mergers including Bell Atlantic-NYNEX and SBC-Pacific Telesis were viewed as a "merger of equals" by the IRS and therefore were allowed to utilize a tax-free "pooling of interest" accounting treatment instead of purchase accounting treatment.

²² In the text, we also compare the combined company with revised synergies (column D) to WorldCom historical (column B).

FINANCIAL RATIOS

- We generated financial ratios for MCI-historical (Column A), WorldCom historical (Column B), MCI-WorldCom pro forma combined (Column C), and MCI-WorldCom pro-forma combined with revised synergies (Column D) based on these adjusted balance sheets and income statements.
- We compared the financial ratios of both the combined MCI-WorldCom pro forma without synergies (Column C) and the combined MCI-WorldCom pro forma with the revised synergies (Column D) against MCI-historical (Column A).²² For each ratio, we note whether there is an improvement over MCI-historical. (These are the pluses and minuses next to the ratios.)
- Finally, in the report, we discuss the implication of the changes in financial strength on the business strategy for the combined MCI-WorldCom.

¹⁵ This document was filed with the Securities and Exchange Commission as Amendment No. 3 to Form S-4, Jan. 22, 1998.

¹⁶ This adjustment represents the excess over book value that WorldCom is paying to purchase MCI's assets. This figure is conservative because it is based on the assumption that WorldCom stock will trade between \$29 to \$41 at the closing of the merger and WorldCom therefore will pay \$51 per MCI share. As WorldCom stock rises above \$41, the amount of goodwill and intangibles added to the balance sheet also increases. As of the date of this analysis, WorldCom stock was trading at \$45, which means that \$31.6

WORLDCOM PRO FORMA CONDENSED COMBINED BALANCE SHEET

As of September 30, 1997 (In millions)

	A	B	C	D	E	F
	MCI Historical	WorldCom Historical	Pro Forma Adjustments	MCI-WorldCom Pro Forma Combined	Revised Synergy Adjustments	MCI-WorldCom Pro Forma Combined w/ Revised Synergies
Current Assets	\$4,603	\$1,625		\$6,228	-	\$6,228
Plant, Property and Equipment (PP&E)	\$13,783	\$5,419	(2,700)	\$16,502	-	\$16,502
Goodwill and Other Intangibles, Net	\$2,366	\$13,002	\$28, 621	\$43,989	-	\$43,989
Other Assets	\$3,965	\$767				
Total Assets	\$24,717	\$20,813	\$25,921	\$71,451	-	\$71,451
Current Liabilities	\$7,327	\$1,870		\$9,197	-	\$9,197
Long Term Debt	\$3,282	\$5,349	\$7,446	\$16,077	-	\$16,077
Shareholders' Equity	\$11,321	\$13,366	\$19,490	\$44,174	-	\$44,177

Source: Columns (A) to (D), Joint Proxy Statement/Prospectus, filed as Amendment No. 3 to SEC Form S-4, January 22, 1998.
Columns (E) and (F), adjustments made by CWA based on "revised estimated synergies" reported in Joint Proxy Statement/Prospectus.

WORLDCOM PRO FORMA CONDENSED INCOME STATEMENT

For the Nine Months Ended September 30, 1997 (In millions)

	A	B	C	D	E	F
	MCI Historical	WorldCom Historical	Pro Forma Adjustments	MCI-WorldCom Pro Forma Combined	Revised Synergy Adjustments	MCI-WorldCom Pro Forma Combined w/ Revised Synergies
Revenue	\$14,545	\$5,349	(280)	\$19,614	—	19,614
Operating Expenses:						
Line Costs	\$8,090	\$2,806	(280)	\$10,616	(1,125)	\$9,491
Selling, General & Administration	\$4,028	\$1,141	—	\$5,169	(750)	\$4,419
Depreciation & Amortization	\$1,475	\$682	537	\$2,281	—	\$2,281
"Write Down" Expense			(413)			
Operating Income	\$952	\$720	(124)	\$1,548	\$1,875	\$3,423
Other Expenses						
Income Tax Provision	\$246	\$261	\$19	\$526	\$975	\$1,501
Interest Expense	\$174	\$235	\$363	\$772	—	\$772
Other	\$139	\$3	—	\$142	—	\$142
Net Income	\$393	\$221	(506)	\$108	\$900	\$1,008
EBIT	\$813	\$717	(124)	\$1,406	\$1,875	\$3,281
EBITDA	\$2,288	\$1,399	\$413	\$3,687	\$1,875	\$5,562

Source: Columns (A) to (D), Joint Proxy Statement/Prospectus, filed as Amendment No. 3 to SEC Form S-4, January 22, 1998.

Columns (E) and (F), Adjustments made by CWA based on "revised estimated synergies" reported in Joint Proxy Statement/Prospectus.

FINANCIAL RATIOS

	A	B	C		D	
	MCI Historical	WorldCom Historical	MCI-WorldCom Pro Forma Combined		MCI-WorldCom Pro Forma Combined w/ Revised Synergies	
Income Generating Capacity of Assets (Asset Productivity)						
Total Revenue/Total Assets	0.588	0.257	0.275	-	0.275	-
Net Income/Total Assets	0.016	0.011	0.002	-	0.014	-
Operating Income/Total Assets	0.039	0.035	0.022	-	0.048	+
Net Income/PP&E	0.029	0.041	0.007	-	0.061	+
EBITDA/Total Assets	0.093	0.067	0.052	-	0.078	-
Working Capital & Liquidity						
Working Capital (millions)	-\$2,724	-\$245	-\$2,969	-	-\$2,969	-
Current Assets/Total Assets	0.186	0.078	0.087	-	0.087	-
PP&E/Total Assets	0.558	0.260	0.231	-	0.231	-
Leverage and Interest Coverage						
Operating Income/Interest	5.471	3.064	2.005	-	4.434	-
Net Income/Interest	2.259	0.940	0.140	-	1.306	-
EBITDA/Interest Expense	13.149	5.953	4.776	-	7.205	-
Fixed Charge Coverage (EBIT/Interest)	4.672	3.051	1.821	-	4.250	-
EBITDA/Debt	0.697	0.262	0.229	-	0.346	-
Debt to Equity	0.290	0.400	0.364	-	0.364	-
Debt to Tangible Assets	0.147	0.685	0.585	-	0.585	-
Profitability and Income Margins						
Operating Income Margin	0.065	0.135	0.079	+	0.175	+
EBITDA Margin	0.157	0.262	0.188	+	0.284	+
Net Income Margin	0.027	0.041	0.006	-	0.051	+

